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NOTE

INCOME, TAXES AND THE CONSTITUTION: WHY THE D.C. CIRCUIT COURT OF APPEALS GOT IT RIGHT IN *MURPHY*

*Russell F. Romond**

In August 2006, the U.S. Court of Appeals for the District of Columbia Circuit (“D.C. Circuit”) struck down an income tax statute on constitutional grounds—the first time in over eight decades that any court has taken such action.¹ In *Murphy v. Internal Revenue Service* (“*Murphy*”), the D.C. Circuit held § 104(a)(2) of the Internal Revenue Code (the “Code”) unconstitutional because it excluded from gross income awards for compensatory damages on account of physical personal injuries, but included awards for such damages on account of nonphysical personal injuries.² The decision was widely criticized by academics and tax professionals, particularly with respect to the D.C. Circuit’s misconceptions regarding the constitutional source of Congress’s taxation power, and many commentators wrote at length about the “parade of horrors” that would inevitably result if the decision were allowed to stand.³

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1. In 1920, the Supreme Court struck down a statute taxing stock dividends as income in *Eisner v. Macomber*, 252 U.S. 189 (1920). However, in 1972, the Tenth Circuit cited constitutional grounds to *expand* the application of a statutory tax exemption in *Moritz v. Comm’r*, 469 F.2d 466 (10th Cir. 1972).

2. 460 F.3d 79, 81 (D.C. Cir.), *vacated*, *Murphy v. IRS*, 2006 WL 4005276 (D.C. Cir. Dec 22, 2006).

3. Professor Paul Caron, of the University of Cincinnati College of Law, said of *Murphy*, “It is difficult to overstate the importance and potential harm of this decision.” Ryan J. Donmoyer, *Tax Law Ruling by Court May Encourage New Challenges* (Aug. 23, 2006), available at <http://www.bloomberg.com/apps/news?pid=20601103&sid=azSsFNBVDjJ8&refer=us>. See also Paul Caron, *Tax Prof Commentary on Murphy*, (Aug.

Murphy warrants controversy. Historically, courts have deferred to legislatures with respect to economic and regulatory legislation, especially where such legislation involves “complex tax laws.”⁴ The IRS promptly filed a petition for a rehearing en banc, but the D.C. Circuit ultimately dismissed the petition as moot.⁵ In a surprising move, the original three-judge panel vacated its decision on its own motion and scheduled a rehearing of the case.⁶ As of this writing, the ultimate outcome of the case is unknown. However, the panel’s original opinion in *Murphy*, though vacated, merits discussion because there the court asked a question that goes to the very foundation of our income tax laws, namely: “What does the government tax when it purports to tax income?”

This article will attempt to answer that question. Part I of this article will briefly summarize the D.C. Circuit’s opinion in *Murphy* and present the issues raised by the decision. Part II will analyze the D.C. Circuit’s opinion and argue that the court ultimately decided *Murphy* correctly, despite some errors in its analysis. This Part will then develop a rule for courts to apply to determine whether a transaction results in an “accession to wealth” within the framework provided by the Supreme Court in *Commissioner v. Glenshaw Glass Co.*,⁷ and revisit *Murphy* within the context of this rule.⁸ This Part will demonstrate that Congress designed the income tax to operate as a tax on net incomes, and not on gross receipts.

Part III will examine and refute the claim that *Murphy* would undermine the very foundation of the income tax and consequently prohibit the taxation of wages. This Part will first address the most common arguments made by “tax protestors”—taxpayers who cite various constitutional objections to paying income taxes—and explain why *Murphy* adds nothing to their arguments. Part III will next apply

23, 2006), available at http://taxprof.typepad.com/taxprof_blog/2006/08/tax_prof_commen.html.

4. See *Nordlinger v. Hahn*, 505 U.S. 1, 11 (1992) (“In structuring internal taxation schemes the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation.”).

5. Order Dismissing Appellees’ Petition for Rehearing En Banc, No. 05-5139 (D.C. Cir. Dec. 22, 2006).

6. Order for Reh’g, No. 05-5139 (D.C. Cir. Dec. 22, 2006).

7. 348 U.S. 426 (1955).

8. This rule is referred to as the “accession to wealth” rule, discussed *infra* notes 116-29.

the accession to wealth rule to examine how Congress taxes wages under the income tax. While it is universally recognized that wages are a source of gross income under § 61(a) of the Code,⁹ the Court has never actually held whether wages—in their entirety—are gains or receipts to the taxpayer. Part III will explore whether the entirety of wages represent gain to the taxpayer, as opposed to merely receipts, and then explain the tax consequences of this distinction by comparing how the Code treats wages compared to transactions in property and income from a trade or business. Part III concludes by suggesting that the current income tax on wages operates similar to a graduated “sales” tax to the wage earner, and proposes that Congress amend the Code to provide wage earners a method to calculate their gains derived from wages to report as gross income.

Part IV will argue that Congress should adopt a “wage expenditure basis” to calculate the proportion of wages that constitutes gross income to wage earners. This Part proposes a formula for calculating this basis, expressed as follows:

$$B_{we} = [P + T + (E_{mw} * 92.35\%)]^{10}$$

According to this formula, the wage gains accruing to the wage earner are the net wages remaining after adjusting for payroll and state income taxes, as well as an adjusted minimum wage payable for an equivalent quantity of labor. This methodology provides three advantages over the way the Code currently taxes wages. First, a wage expenditure basis is equitable because it brings wages, as a source of income, into parity with capital gains and income from a trade or business, both of which incorporate the notion of “gain” by adjusting for the costs of production of income. Second, it would enhance the progressive nature of the current tax structure and provide tax relief to low income workers and two-earner families. Finally, it is relatively easy to implement and leaves intact the other provisions of the Code that provide credits, deductions and exemptions for dependents and personal expenses.

9. I.R.C. § 61(a) (2000).

10. Where:

B_{we} = Wage expenditure basis;

P = Payroll taxes;

T = State and local income taxes withheld; and

E_{mw} = Minimum wage equivalent for the amount of labor performed.

I. *MURPHY V. INTERNAL REVENUE SERVICE*A. Background

Marrita Murphy filed a claim with the Department of Labor alleging unlawful discrimination and retaliation by her former employer.¹¹ An administrative law judge awarded Murphy \$70,000 in compensatory damages, \$45,000 of which was for “emotional distress or mental anguish” and \$25,000 of which was for “injury to professional reputation.”¹² Murphy included her award as “gross income” on her 2000 tax return and paid \$20,665 in taxes.¹³

Murphy later filed an amended return with the Internal Revenue Service (“IRS”) seeking a tax refund for this payment.¹⁴ After the IRS denied Murphy’s request, she filed suit in federal court.¹⁵ The district court ruled against her and Murphy appealed to the D.C. Circuit.¹⁶ In her complaint, Murphy first claimed that she was entitled to a refund under § 104(a)(2) of the Code because her award compensated for physical injuries, and thus should have been excluded from gross income.¹⁷ Murphy alternatively claimed that § 104(a)(2) was unconstitutional as applied to her award because her damages were compensatory and thus not “income” within the meaning of the Sixteenth Amendment.¹⁸ The court rejected Murphy’s first claim on the merits.¹⁹ Their ruling on her second claim is the basis for this article.

In her second claim, Murphy argued that her award was neither a gain nor an accession to wealth, but instead a return of “human capital” and thus not income.²⁰ According to this human capital theory, “a damage award for personal injuries—including nonphysical injuries—is not income but simply return of capital—‘human capital.’”²¹ Murphy

11. See *Murphy v. IRS*, 460 F.3d 79, 81 (D.C. Cir. 2006).

12. *Id.*

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.* at 82.

17. *Id.*

18. *Id.*; U.S. CONST. amend. XVI (“The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.”).

19. See *Murphy*, 460 F.3d at 84.

20. *Id.* at 85.

21. *Id.*

cited to the Supreme Court's decision in *Commissioner v. Glenshaw Glass Co.*, a 1918 Attorney General Opinion ("1918 Opinion"), a 1918 revenue ruling ("1918 Ruling"), and a House Report on the Revenue Act of 1918 ("1918 House Report") in support of her argument.²² In *Glenshaw Glass*, the Court recognized the "long history of . . . holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital" when it distinguished punitive damages from compensatory damages as a source of taxable income.²³ Similarly, the 1918 Opinion stated that proceeds from an accident insurance policy are capital, as distinguished from income, because they "merely take the place of capital in human ability which was destroyed by the accident."²⁴ The 1918 Ruling made the same conclusion with respect to damages or settlement awards received for accident injuries.²⁵ The 1918 House Report also expressed doubt as to whether compensatory damages would be required to be included in gross income.²⁶ Murphy argued that compensatory damages of this sort were commonly understood to be excluded from income at the time the Sixteenth Amendment was ratified.²⁷

The Government responded with several arguments. First, it invoked the presumption that "Congress enacts laws within its constitutional limits."²⁸ Second, it asserted that Congress could, at its discretion, repeal § 104(a)(2) in its entirety and constitutionally tax all compensatory damages.²⁹ Third, it argued that the Court's discussion of "human capital" in footnote eight of *Glenshaw Glass* referred only to a since-abandoned congressional policy.³⁰ Finally, they dismissed Murphy's "human capital" argument as a flawed analogy to financial capital or property because the latter items have a "basis," from which income is calculated as "the excess of the amount realized therefrom over the adjusted basis."³¹ Unlike property, the Government contended,

22. *Id.* at 85-86 (citing *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); 31 Op. Att'y. Gen. 304 (1918); T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918); H.R. Rep. No. 65-767 (1918)).

23. *Id.* at 85 (citing *Glenshaw Glass Co.*, 348 U.S. at 432 n.8).

24. *Id.* at 86 (citing 31 Op. Att'y. Gen. at 308).

25. *Id.* at 86.

26. *Id.* at 86 (citing H.R. Rep. No. 65-767, at 9-10).

27. *Id.* at 86.

28. *Id.*

29. *Id.*

30. *Id.* at 86-87.

31. *Id.* (citing I.R.C. § 1001(a)).

“people do not pay cash or its equivalent to acquire their well being, [thus] they have no basis in it for measuring a gain (or loss) upon the realization of compensatory damages.”³²

B. The D.C. Circuit's Decision

The D.C. Circuit ruled in Murphy's favor and awarded her a refund of her tax payment, plus applicable interest.³³ The court held that “[t]he Sixteenth Amendment simply does not authorize the Congress to tax as incomes every sort of revenue a taxpayer may receive.”³⁴ While the court did concede that “the Supreme Court has broadly construed the phrase ‘gross income,’” the court noted that the Supreme Court also “has made plain that the power to tax incomes extends only to ‘gains’ or ‘accessions to wealth.’”³⁵

The court first applied the Supreme Court's analysis in *O'Gilvie v. United States*,³⁶ and considered “whether the taxpayer's award of compensatory damages is ‘a substitute for [a] normally untaxed personal . . . quality, good, or ‘asset.’”³⁷ The court reasoned that Murphy's emotional well-being and good reputation were not taxable as income; therefore, compensatory damages for their loss likewise could not be considered income.³⁸ Thus, the court held that “the Sixteenth Amendment does not empower the Congress to tax her award.”³⁹

The D.C. Circuit next applied the Supreme Court's approach in *Merchant's Loan & Trust Co. v. Smietanka*,⁴⁰ and examined the original understanding of “income” at the time the Sixteenth Amendment was adopted.⁴¹ Although the court did not rely on the 1918 House Report, it agreed with Murphy that the 1918 Opinion and the 1918 Ruling

32. *Id.*

33. *Id.* at 92.

34. *Id.* at 87 (citing *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110, 114 (1925) (“Congress cannot make a thing income which is not so in fact.”)).

35. *Id.* at 88 (citing *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 430, 431 (1955)).

36. 519 U.S. 79, 86 (1996).

37. *See* *Murphy v. IRS*, 460 F.3d 79, 88 (D.C. Cir. 2006) (citing *O'Gilvie*, 519 U.S. at 86).

38. *Id.* (“[I]t is clear from the record that the damages were awarded to make Murphy emotionally and reputationally ‘whole’ and not to compensate her for lost wages or taxable earnings of any kind.”).

39. *Id.*

40. 255 U.S. 509, 519 (1921).

41. *See* *Murphy*, 460 F.3d at 89-91.

indicated that incomes did not include “monies received solely in compensation for a personal injury and unrelated to lost wages or earnings.”⁴² The court noted a number of nonphysical injuries for which compensatory damages were available under state tort law as support for the conclusion that they were “not regarded differently than was compensation for injuries and, therefore, not considered income” by those who ratified the Sixteenth Amendment.⁴³ Then, in a conclusion that was nothing short of astonishing, the D.C. Circuit concluded:

In sum, every indication is that damages received solely in compensation for a personal injury are not income within the meaning of that term in the *Sixteenth Amendment*. First, as compensation for the loss of a personal attribute, such as well-being or a good reputation, the damages are not received in lieu of income. Second, the framers of the *Sixteenth Amendment* would not have understood compensation for a personal injury—including a nonphysical injury—to be income. *Therefore, we hold § 104(a)(2) unconstitutional insofar as it permits the taxation of an award of damages for mental distress and loss of reputation.*⁴⁴

C. Reaction

Murphy is the first decision to strike down a tax statute as unconstitutional in over 80 years.⁴⁵ The decision has generated as much controversy as can be expected from a milestone of this magnitude and has captured the attention of both tax professionals and the public at large. Reaction from tax professionals and academics has been overwhelmingly negative. Tax professors and constitutional law professors united (in what would be an unlikely alliance under any other circumstance) to denounce the opinion as “flawed,” “odd,” “bizarre,” and “horrible.”⁴⁶ Tax professionals fear that the decision will give renewed inspiration to “tax protestors,” while legal scholars caution about the risks of increased judicial scrutiny of Congress’s power to

42. *Id.*

43. *Id.* at 91.

44. *Id.* at 92 (emphasis added).

45. *See supra* note 1.

46. *See* Paul Caron, *Tax Profs Weigh in on Murphy in Tax Notes* (Sept. 5, 2006), available at http://taxprof.typepad.com/taxprof_blog/2006/09/tax_prof_weigh.html; *see also* Caron, *supra* note 3.

tax.⁴⁷ Personal injury lawyers, by contrast, have applauded the court's ruling,⁴⁸ and at least one economist has suggested that its rationale applies with equal force to the risk-free rate of interest.⁴⁹

The reaction to *Murphy* should not be surprising. Courts have traditionally deferred to legislatures' exercise of the power of taxation, and the legal community has both accepted and defended this practice. Courts justify this deference not only on the basis of the need for tax revenue to enable a functioning government, but also on the basis of the Court's broader practice of legislative deference with respect to economic legislation.⁵⁰

Tax legislation, however, can be distinguished from other economic legislation in a number of ways. Generally, regulatory economic legislation is designed to set basic "ground rules" for, and ensure a level playing field among, those who voluntarily participate in the object of the regulation.⁵¹ Tax legislation, by contrast, draws hundreds of

47. See Tom Herman, *Court Ruling in Damages Case Deals Big Setback to the IRS*, WALL ST. J., Aug. 30, 2006, at D2; see also Peter Lattman, *Bombshell Tax Decision From D.C. Circuit* (Aug. 24, 2006), available at <http://blogs.wsj.com/law/2006/08/24/bombshell-tax-decision-from-dc-circuit/>; see also Caron, *supra* notes 3 and 46.

48. See Robert W. Wood, *Tax-Free Damages: Murphy's Law Opens Floodgates* (Sept. 4, 2006), available at: <http://www.rothcpa.com/archives/002117.php#002117>.

49. See Bruce Bartlett, *What Can the Government Tax?* (Aug. 30, 2006), available at <http://www.woodporter.com/pdf/TN090406.pdf>.

50. See, e.g., *United States v. Carlton*, 512 U.S. 26 (1994) (holding that retroactive federal estate tax legislation was neither illegitimate nor so arbitrary as to violate the Due Process Clause of the Fifth Amendment); see also *Nordlinger v. Hahn*, 505 U.S. 1 (1992) (declaring that tax classifications need only rationally further a legitimate state interest, so long as there is any plausible policy reason for the classification); see also *Madden v. Kentucky*, 309 U.S. 83, 88 (1940) ("the presumption of constitutionality can be overcome only by the most explicit demonstration that a classification is a hostile and oppressive discrimination against particular persons and classes"); see also *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 24 (1916). In *Brushaber*, the Supreme Court held that

a constitutional violation is warranted only where although there was a seeming exercise of the taxing power, the act complained of was so arbitrary as to constrain to the conclusion that it was not the exertion of taxation but a confiscation of property, that is, a taking of the same in violation of the Fifth Amendment, or, what is equivalent thereto, was so wanting in basis for classification as to produce such a gross and patent inequality as to inevitably lead to the same conclusion.

Brushaber, 240 U.S. at 24.

51. See, e.g., 29 U.S.C. §§ 201-219 (2000) ("The Fair Labor Standards Act"); see also 15 U.S.C. §§ 78a-nn (2000) ("The Securities Exchange Act").

distinctions among otherwise similarly situated taxpayers according to varied and specific criteria.⁵² Tax legislation also implicates a number of personal rights that the Court has held to be fundamental in other contexts, such as marriage, family, the right to work and property.⁵³ In this context, it is far from intuitive why courts should afford legislators more deference to define “income” than to define “speech,” “due process,” or “cruel and unusual.”⁵⁴

The next part of this article will analyze *Murphy* in the context of Congress’s power to tax, as well as Supreme Court precedent interpreting this power. As discussed in detail below, the D.C. Circuit ultimately took the wrong road, but arrived at the right place. Critics are right to call attention to the flaws in the decision; however, these flaws are not the real cause of the controversy. Court decisions do not attract widespread and sustained assault simply for holding a statute inapplicable to one specific type of compensatory damage award. The controversy surrounding *Murphy* is the result of one sentence: “*The Sixteenth Amendment simply does not authorize the Congress to tax as ‘incomes’ every sort of revenue a taxpayer may receive.*”⁵⁵ The controversy surrounding *Murphy* exists because although courts have long recognized the truth in this proposition,⁵⁶ few courts have acted to enforce it.⁵⁷

52. For example, § 1 classifies tax liability according to income amount (5 tax brackets) and filing status (4 classifications). I.R.C. § 1. Eligibility for certain adjustments to gross income are determined by gross income thresholds, and exemptions and itemized deductions are available only where adjusted gross income is below a stipulated amount and phases out when adjusted gross income exceeds a stipulated amount. See discussion *infra* notes 183-84.

53. See, e.g., *Meyer v. Nebraska*, 262 U.S. 390 (1923); see also *Loving v. Virginia*, 388 U.S. 1 (1967); see also *Moore v. East Cleveland*, 431 U.S. 494 (1977).

54. U.S. CONST. amends. I, V, VIII, XIV and XVI.

55. See *Murphy v. IRS*, 460 F.3d 79, 87 (D.C. Cir. 2006) (emphasis added).

56. See discussion *infra* Part II.D.

57. See *supra* notes 1, 4 and 50.

II. MURPHY, TAXATION & THE “ACCESSION TO WEALTH RULE”

A. Analysis: The Wrong Road to the Right Place1. The Wrong Road

a. Constitutional Interpretation

The D.C. Circuit traced Congress’s taxation power to the Sixteenth Amendment; however, the Constitution expressly grants Congress the authority to tax in Article I,⁵⁸ subject to two constraints. Article I, § 8 requires that all indirect taxes “be uniform throughout the United States.”⁵⁹ Article I, § 9 requires Congress to apportion direct taxes among the states according to population as determined by a census.⁶⁰

The Sixteenth Amendment did not grant Congress any new power; it merely removed the apportionment requirement with respect to one object of taxation—incomes.⁶¹ This much is plain from the text of the amendment: “The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.”⁶²

This fact is not a minor technical point. States ratified the Sixteenth Amendment in direct response to a Supreme Court decision that struck down a federal income tax act as an unconstitutional direct tax.⁶³ The distinction between direct and indirect taxes, though largely academic today, must be understood in this historical context. The Supreme Court has interpreted “direct tax” to mean a tax levied directly on property because of its *ownership* and “indirect tax” as a tax “not levied directly on property because of its ownership, but rather on its *use*.”⁶⁴ Thus, as a general rule, indirect taxes include taxes imposed on activity, such as

58. U.S. CONST. art. I, § 8. This power is plenary, as the Court has recognized that Congress’s power to tax is “exhaustive and embraces every conceivable power of taxation [that it] has never been questioned, or if it has, has been so often authoritatively declared as to render it necessary only to state the doctrine.” *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 12 (1916).

59. U.S. CONST. art. I, § 8, cl. 1.

60. U.S. CONST. art. I, § 9, cl. 4.

61. See *Brushaber*, 240 U.S. at 18.

62. U.S. CONST. amend. XVI.

63. *Pollock v. Farmers’ Loan & Trust Co. (Pollock I)*, 157 U.S. 429 (1895).

64. *Brushaber*, 240 U.S. at 14 (emphasis added) (discussing *Pollock I*).

consumption, the exercise of a privilege, or some other transaction, while direct taxes are taxes imposed on persons or property.⁶⁵

The Court struck down the Tariff Act of 1894 (the “Act”) in *Pollock v. Farmer’s Loan and Trust Co.* on the basis of these definitions.⁶⁶ In *Pollock I*, the Court reasoned that apportionment, by operation, produced inequalities among the states and thus “must be held to have been contemplated, and was manifestly designed to operate to restrain the exercise of the power of direct taxation to extraordinary emergencies, and to prevent an attack upon accumulated property by mere force of numbers.”⁶⁷ Stating that Congress cannot be allowed to accomplish indirectly what it cannot do directly, the Court concluded that a tax on income from property was not “so intrinsically different from a tax on [the property] itself as belonging to a wholly different class of taxes,” and therefore must be apportioned among the states.⁶⁸

Prior to *Pollock I*, income taxes were generally regarded as indirect excise taxes.⁶⁹ To the extent that *Pollock I* held otherwise, its holding rested squarely on the basis of the underlying *source* of the income.⁷⁰ Indeed, when considering the constitutionality of the remainder of the Act upon rehearing, the Court was careful to state:

We have considered the act only in respect of the tax on income derived from real estate, and from invested personal property, and have not commented on so much of it as bears on gains or profits from business, privileges, or employments [sic], in view of the

65. Prior to the Sixteenth Amendment, courts strained to classify taxes as indirect. In *Magoun v. Illinois Trust and Savings Bank*, 170 U.S. 283 (1898), the Court held that an inheritance tax was a tax on succession—a beneficiary’s right to receive property—rather than as a direct tax on the decedent’s estate itself. *See also* *Knowlton v. Moore*, 178 U.S. 41 (1900). In *Hylton v. United States*, 3 U.S. 171 (1796), the Court held that a federal tax on carriages was an excise tax on the carriage owners’ operations (the “conveyance of persons”), and not a direct tax on the ownership of the carriages themselves.

66. *Pollock I*, 157 U.S. at 583.

67. *Id.*

68. *Id.* at 581.

69. *Brushaber*, 240 U.S. at 15.

70. *See* *Pollock v. Farmers’ Loan & Trust Co. (Pollock II)*, 158 U.S. 601, 633-36 (1895). Upon rehearing, the Court considered whether the remainder of the Tariff Act of 1894 was constitutional after the Court invalidated the provisions taxing income from property in *Pollock I*. *Id.* The Court held that Congress could not have intended for the burden of the tax to fall on labor and occupations, and struck the remainder of the act. *Id.* at 637.

instances in which taxation on business, privileges, or employments has assumed the guise of an excise tax and has been sustained as such.⁷¹

The Court did not hold that Congress could not tax incomes, nor did it in any way limit the scope of incomes that Congress could tax.⁷² *Pollock I* simply held that certain incomes must be taxed in a certain way.⁷³ It is clear from the opinion that, if it wished, Congress could have levied an apportioned direct tax on incomes derived from property. To the extent that the Court considered the definition of income at all, it was only in the context of considering the Act's definition of income as applied to property.⁷⁴

States ratified the Sixteenth Amendment specifically to release Congress from the obligation of classifying incomes by source and providing for apportionment where necessary.⁷⁵ The Amendment did not alter Congress's power with the phrase "Congress shall have the power to lay and collect taxes on incomes," but with the words "from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."⁷⁶

The D.C. Circuit erred in *Murphy* because a statute could not possibly violate an *enabling* amendment that serves to remove a limitation upon what is otherwise plenary authority under Article I.⁷⁷ It is impossible to hold that *Murphy's* award was not income as defined by

71. *Id.* at 635.

72. *Brushaber*, 240 U.S. at 16-17.

73. *Id.*

74. *Pollock v. Farmers' Loan & Trust Co. (Pollock I)*, 157 U.S. 429, 583 (1895).

75. *Brushaber*, 240 U.S. at 18. There, the Supreme Court reasoned that the [Sixteenth] Amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock* Case was decided, that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment.

Id.

76. U.S. CONST. amend. XVI.

77. Prior to the Sixteenth Amendment (but after *Pollock I*), Congress could have chosen to enact apportioned taxes on incomes from property. The Sixteenth Amendment served only to remove that constraint. To the extent that the award is capital or property, it may still be subject to taxation under Article I, § 9. Therefore, to the extent that the taxation of *Murphy's* award violated any constitutional provision, it violated Article I, § 9.

the Sixteenth Amendment because the Sixteenth Amendment makes no attempt to define income. The Sixteenth Amendment is relevant only to the extent that *if* Murphy's award was in fact income, then Congress had plenary authority to tax it under Article I. Consequently, the court had three options in *Murphy*: (1) decide whether the award was income subject to income tax, (2) hold the award to be property subject only to apportioned direct taxes, or (3) sustain the tax as an excise tax on the entire amount of the award, regardless of whether it was income.⁷⁸

b. Statutory Construction

The court also erred in its interpretation of § 104(a)(2) of the Code⁷⁹ and its construction of that section's relationship to § 61(a).⁸⁰ Section 104(a)(2) does not, as the court stated, "make [Murphy's] award taxable as income."⁸¹ Rather, § 104(a)(2) fails to *exclude* Murphy's award *from* taxable income.⁸² Absent another statutory exclusion, the proper inquiry should focus on whether § 61(a) includes the award in gross income.⁸³

Section 61(a) defines "gross income" as "all income from whatever source derived, including (but not limited to) [15 enumerated sources]."⁸⁴ The Supreme Court has interpreted this section to extend to "all gains," from whatever source derived, "except those specifically exempted."⁸⁵ It follows then, that courts should first consider whether a specific exclusion applies to a particular receipt, and if it finds no such exclusion, consider whether the amount in question is in fact a "gain . . .

78. The court was correct to choose the first option. *See* discussion *infra* notes 154-60.

79. I.R.C. § 104(a)(2).

80. *Id.* § 61(a).

81. *See* *Murphy v. IRS*, 460 F.3d 79, 85 (D.C. Cir. 2006).

82. I.R.C. § 104(a) states that for purposes of § 104(a)(2), emotional distress shall not be treated as a physical injury or sickness, except to the extent of medical expenses attributable to emotional distress. This text in effect renders unnecessary an inquiry into whether the amounts *spent* are actually income. It does not justify the conclusion that the *remainder* of such awards are in fact income.

83. *See* *Comm'r v. Banks*, 543 U.S. 426, 433 (2005) ("The definition [of gross income] extends broadly to all economic gains not otherwise exempted.").

84. I.R.C. § 61(a).

85. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955); *accord Banks*, 543 U.S. at 433.

derived from any source whatever.”⁸⁶

Neither § 104(a)(2) nor any other exclusionary statute specifically provides for the exclusion of Murphy’s award. This fact alone, however, fails to affirmatively establish that the award is actually income. The absence of an exclusionary statute only establishes that compensatory damage awards are a *source* of income for the purpose of calculating gross income.⁸⁷ It does not necessitate a conclusion that the award is *in fact* income to the taxpayer. Such a conclusion could only be the result of an analysis of the nature, characteristics, and circumstances giving rise to the award.

The D.C. Circuit should have held that Murphy was not required to include the award as gross income under § 61(a). Alternatively, because such awards fall within the scope of sources from which gross income *could* be derived, the court also could have held that Murphy was required to report “0” as the amount of income attributable to her award. There was no need, however, for the court to declare § 104(a)(2) unconstitutional for failing to stipulate certain exclusions, but not others,⁸⁸ particularly when the court was able to arrive at the same result simply by applying the language of the statute to the facts at issue.

c. *Glenshaw Glass*, Not *O’Gilvie* or *Merchant’s*

The D.C. Circuit’s mistaken interpretation of the Sixteenth Amendment could be set aside as a point more important to constitutional scholars than to the outcome of the case. Even the court’s striking of § 104(a)(2) “as applied” to Murphy’s award could stand on the basis that the section would still apply to the theoretically conceivable yet practically impossible instance where a court awards a taxpayer compensatory damages for nonphysical injuries that exceed the value of the actual injury.⁸⁹ The D.C. Circuit erred more seriously,

86. *Glenshaw Glass Co.*, 348 U.S. at 429.

87. See discussion *infra* notes 186-91 and accompanying text.

88. In *Moritz v. Commissioner*, 469 F.2d 466, 470 (10th Cir. 1972), the Tenth Circuit held that eligibility for a dependent care deduction (I.R.C. § 214(a)) impermissibly discriminated on the basis of gender. Instead of holding § 214(a) unconstitutional, the court expanded the eligibility for the deduction to include both genders. *Id.*

89. “Damages for personal injury are by definition compensatory only.” *Glenshaw Glass Co.*, 348 U.S. at 432 n.11. As a matter of law, compensatory damages will always equal the value of the injury, resulting in no gain to the injured party. Any excess damages would be punitive.

however, when it mistakenly applied the Supreme Court's decisions in *O'Gilvie v. United States*⁹⁰ and *Merchants' Loan & Trust Co. v. Smietanka*⁹¹ instead of the rule set forth in *Commissioner v. Glenshaw Glass & Co.*⁹²

O'Gilvie was a case about statutory interpretation, not a case about the definition of income.⁹³ The question at issue in *O'Gilvie* was whether the prior version of § 104(a)(2), which excluded the "amount of any damages . . . on account of personal injuries or sickness," excluded punitive as well as compensatory damages through the use of the phrase "on account of."⁹⁴ The issue in *O'Gilvie* was not whether Congress *could* tax punitive damages as income—that issue was decided over forty years earlier in *Glenshaw Glass*.⁹⁵ The issue was whether the ambiguous language of the statute *actually* excluded punitive damages.⁹⁶ The Court considered whether the damages were "a substitute for [a] normally untaxed personal . . . quality, good, or 'asset'" only to the extent that it was indicative of congressional intent.⁹⁷ In *Murphy*, Congress's intent to tax compensatory damages for nonphysical injuries was clear—the issue before the court was whether Congress *could*.

Though the "substitute" analysis applied in *O'Gilvie* can be indicative of whether an item is "income," it is not determinative. Congress can, and does, choose not to tax certain forms of income as a matter of public policy.⁹⁸ Similarly, the Court has never given significant weight to whether an item is historically untaxed in deciding whether or not it is income. To the contrary, the Court in *Glenshaw Glass* expressly dismissed the argument that punitive damages were not taxable because they were not taxed in prior versions of the Code.⁹⁹

90. 519 U.S. 79 (1996).

91. 255 U.S. 509 (1921).

92. 348 U.S. at 431.

93. See *O'Gilvie*, 519 U.S. at 81.

94. *Id.*

95. See *Glenshaw Glass Co.*, 348 U.S. at 432-33.

96. See *O'Gilvie*, 519 U.S. at 81.

97. *Id.* at 86-87.

98. For example, in *Gould v. Gould*, 245 U.S. 151 (1917), the Supreme Court held that alimony payments made to a wife are taxable to the husband. Currently, the Code allows a taxpayer to exclude payments for a spouse and requires the payee spouse to include the payments in gross income. See I.R.C. §§ 71, 215.

99. See *Glenshaw Glass Co.*, 348 U.S. at 431-32; see also *Cent. Ill. Pub. Serv. Co. v. United States*, 435 U.S. 21, 25 (1978) (holding that the fact that item is not subject to withholding does not mean that it is not gross income).

The “substitute” analysis would require not only the exclusion of other compensation payments that would be “accessions to wealth” under *Glenshaw Glass*, but would also exclude other items currently taxed under the Code. For example, suppose a company purchased a building for \$600,000. Now suppose that five years later, when the building had a fair market value of \$700,000, it was destroyed due to a contractor’s negligence. The company recovers \$700,000 from the contractor. Even though a building is an asset normally untaxed by Congress, the taxpayer has realized a gain of \$100,000.¹⁰⁰ While this gain is properly taxed as income under § 170 of the Code,¹⁰¹ the *O’Gilvie* analysis would dictate the opposite result.

Furthermore, the court’s reliance on original understanding is unnecessary. Although the court cited *Merchants’ Bank* as authoritative, courts have since emphasized plain meaning in its interpretations of tax laws.¹⁰² “Income” is a limited concept with certain characteristics that have been consistently recognized, similar to “property” and “contracts.”¹⁰³ Moreover, while the Court did look to original understanding in *O’Gilvie*, it did so only to determine the *legislative intent of a statute*, not for guidance on the definition of income.¹⁰⁴

d. No Accession to Wealth

The D.C. Circuit should have resolved *Murphy* through a straightforward application of *Glenshaw Glass*. In *Glenshaw Glass*, the Court addressed whether income from a particular source is taxable.¹⁰⁵ The definition of income was not at issue, as the Court recognized the

100. See William A. Klein et al., *Federal Income Taxation*, 140 (13th ed. 2003).

101. See I.R.C. § 170(h)(2).

102. See *Glenshaw Glass Co.*, 348 U.S. at 432; see also *Helvering v. Edison Bros. Stores, Inc.*, 133 F.2d 575, 579 (8th Cir. 1943) (“The meaning of the word ‘income’ in the Sixteenth Amendment and the acts of Congress pursuant [thereto] is that given it in common speech and every day usage.”).

103. See discussion *infra* notes 116-17 and 130-31.

104. See *supra* notes 93-103 and accompanying text.

105. 348 U.S. at 430. Punitive damages were not specifically enumerated, and the Court was interpreting the effect of the “catchall provision” of § 22(a) (the predecessor statute to § 61(a)). *Id.* The Court explained “we cannot but ascribe content to the catchall provision of § 22(a), ‘gains or profits and income derived from any source whatever.’ The importance of that phrase has been too [sic] frequently recognized since its first appearance in the Revenue Act of 1913 to say now that it adds nothing to the meaning of ‘gross income.’” *Id.*

award was (1) an accession to wealth, (2) clearly realized, and (3) one over which the recipient exercised complete dominion.¹⁰⁶ The Court has since consistently defined income in the context of these three elements.¹⁰⁷ *Murphy* presented a different issue: the parties contested the award's classification as income, not whether the award was a source of taxable income. Still, an examination of *Murphy*'s award in the context of the Court's definition of income in *Glenshaw Glass* suggests that the D.C. Circuit was correct in holding that the award was not income.

Realization and dominion were not at issue in *Murphy*; the record is clear that both elements were satisfied.¹⁰⁸ The decisive issue was whether *Murphy*'s award was in fact an "accession to wealth." The Government argued that *Murphy*'s entire award was an accession to wealth, while *Murphy* argued that no part of the award met that condition.¹⁰⁹

Unfortunately, the Supreme Court has not provided clear guidance on how to determine whether an amount is an "accession to wealth," as each subsequent case turned on its own set of facts.¹¹⁰ As a result, each party in *Murphy* had to articulate its points in terms of existing tax concepts, resulting in awkward arguments on both sides. *Murphy*'s claim rested on the notion of "human capital," a notion discussed in dicta but never completely adopted by either Congress or the Court.¹¹¹ The Government argued that human beings have a "zero basis" in their well-being and that taxpayers are not permitted to depreciate themselves.¹¹²

Not surprisingly, awkward arguments resulted in an awkward opinion. Without accepting *Murphy*'s "human capital argument," the court held that the purpose of *Murphy*'s award was to restore her to the "*status quo ante*," e.g., the economic equivalent of her position prior to

106. *Id.* at 431. The Court thus adopted a broader definition of income than it had previously applied in *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (defining income as "the gain derived from capital, from labor, or from both combined").

107. *See, e.g.,* *Comm'r v. Banks*, 543 U.S. 426 (2005), discussed *infra* notes 125-29; *see also* *Comm'r v. Kowalski*, 434 U.S. 77, 83 (1977).

108. *See* *Murphy v. IRS*, 460 F.3d 79, 81 (D.C. Cir. 2006).

109. *Id.* at 85-88.

110. The "substitute" analysis from *O'Gilvie* would be helpful here as the results would often be similar, but from a doctrinal perspective, that approach has flaws for the reasons discussed *supra* notes 98-100.

111. *See* *Murphy*, 460 F.3d at 85.

112. *See id.* at 87.

her injury, and thus the award was neither a “gain” nor an “accession to wealth.”¹¹³ While the court’s decision was intuitively correct, the fact that its opinion was not written in conventional tax terminology provided the basis for a substantial amount of criticism.¹¹⁴

B. A Rule for Determining an “Accession to Wealth”

Murphy demonstrates the need for the Supreme Court to provide clear guidance on how to distinguish “accessions to wealth” from the broader category of receipts. This distinction is necessary because the Supreme Court has recognized that “income” is not simply a label that Congress may apply to any item it wishes to tax. As *Murphy* correctly noted, “Congress cannot make a thing income which is not so in fact.”¹¹⁵ It is currently unclear what facts courts should consider when determining whether there has been an “accession to wealth” under *Glenshaw Glass*. Should courts examine the receipt of the award, in isolation, as the Government suggested in *Murphy* or should courts look to events as a whole, and consider amounts in the context of the events that resulted in their receipt? Are courts constrained only to those principles recognized in the Code or should courts also consider the inherent characteristics of the alleged taxable event?

The Supreme Court has consistently recognized an event or transaction as a gain or an accession to wealth where the total accretion of wealth to the taxpayer attributable to a transaction or event exceeds the diminution of wealth the taxpayer incurred from such transaction or event.¹¹⁶ This interpretation, referred to throughout the remainder of this article as the “accession to wealth rule” (or, “the rule”), applied within the *Glenshaw Glass* framework, justifies early precedents involving punitive damages, windfalls, and treasure troves, as well as the exclusion of compensatory damages, returns of capital, and stock dividends, and is consistent with the Code’s existing notion of basis.¹¹⁷

113. *See id.* at 88.

114. *See* discussion *supra* notes 3 and 46.

115. *Murphy*, 460 F.3d at 87.

116. In this context, the *O’Gilvie* analysis is helpful in separating the gain from what would normally go untaxed. Thus, in the example in Part A, *supra*, the \$100,000 gain would be separated from the cost of the untaxed house destroyed, which would be consistent with recognizing no gain attributable to compensating *Murphy* for her untaxed well-being and reputation.

117. Indeed, the denial of a recognition of a “net gain” concept would require a

C. The Accession to Wealth Rule in the Context of
Supreme Court Precedent

In *Glenshaw Glass*, both awards at issue were accessions to wealth because the accretions and diminutions of wealth were presumed, as a matter of law, when the trial court awarded the respondents compensation for lost profits.¹¹⁸ The court's punishment of the *offending* parties, by contrast, did not in any way diminish the *victims'* wealth.¹¹⁹ Consequently, the accretion of the victims' wealth attributable to punitive damages exceeded the victims' diminution of wealth by the entire amount of the award. It was clear from the record that the victims each realized and exercised dominion over these awards, so the Court properly deemed the damages to be income.

The rule also justifies the exclusion of stock dividends in *Eisner v. Macomber* because although there was an accession to wealth over which shareholders exercised complete dominion, the shareholders did not realize these dividends.¹²⁰ In that case, there would have been an accession to wealth to the shareholder due to the increase in the value of the net assets of the underlying corporation. This much would be true whether Standard Oil issued a stock dividend or no dividend whatsoever.¹²¹ Each shareholder exercised complete dominion over its

curious interpretation of *Glenshaw Glass*—that wherever receipt of an amount results in any accession to wealth to the recipient, the *entire* amount received would be taxable *regardless* of the actual amount of the accession to wealth by the recipient. Such an interpretation would be inconsistent with prior decisions distinguishing receipts from incomes, particularly *Stewart Dry Goods Co. v. Lewis*, discussed *infra*, notes 138-47.

118. Compensatory damages for lost profits are calculated by assuming, as a matter of law, that business operations prevented by the events giving rise to plaintiff's claim had, in fact, occurred. Therefore, courts construct sales (accretions of wealth) and costs (diminutions of wealth) and award the lost profit (the accession to wealth). Even though these damages are "compensatory," they compensate *for* an accession to wealth, and are rightly taxable. The determination of lost profits in *Glenshaw Glass* is discussed at length in the lower court opinions. See *Comm'r v. Glenshaw Glass Co.*, 211 F.2d 928 (3d Cir. 1954); see also *Glenshaw Glass Co. v. Comm'r*, 18 T.C. 860 (1954).

119. See *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955); see also *supra* notes 93-101 and accompanying text.

120. 252 U.S. 189, 208-12 (1920).

121. See *id.* at 211-12. The shareholder's wealth would increase by the incremental increase in value of the corporation's assets as represented by that shareholder's shares, regardless of whether the corporation retains this value or distributes it as a dividend.

shares by virtue of their ownership,¹²² yet did not *realize* this accession to wealth, because, as the Court stated, the “essential and controlling fact is that the stockholder has received nothing out of the company’s assets for his separate use and benefit.”¹²³ The Court then added that “[f]ar from being a realization of profits . . . [stock dividends] tend[] rather to postpone such realization.”¹²⁴

At first glance, the Court’s holding in *Commissioner v. Banks* seems inconsistent with the accession to wealth rule.¹²⁵ In *Banks*, the taxpayers received punitive damages and excluded from gross income the portion of the award paid as contingency fees to their attorneys.¹²⁶ The taxpayers argued that they never exercised complete dominion over the portion of the award paid as contingency fees, and the Court ruled against them by applying the anticipatory assignment of income doctrine.¹²⁷ The taxpayers did not challenge the inclusion of the entire award as an accession to wealth nor did they argue that the denial of a deduction for legal fees was inequitable. In an amicus brief, the Association of Trial Lawyers of America argued that the fees should be subtracted as a capital expense from the disposition of personal property.¹²⁸ This argument bears similarities to arguments challenging the amount of an accession to wealth, but the Court declined to consider the argument because it was the first time the argument was presented in the case and it had not been examined by the Court of Appeals.¹²⁹

D. A Tax on Net Income

This is not to say that courts should apply the accession to wealth rule in every case where a taxpayer claims a payment is not income, but only to say that courts should ensure that Congress levies the income tax

122. *See id.* at 208-09.

123. *Id.* at 211.

124. *Id.*

125. 543 U.S. 426 (2005). *Banks* is the Court’s most recent occasion to consider the issue of income in the context of *Glenshaw Glass*.

126. *Id.* at 429-32.

127. *Id.* at 434-38.

128. *Id.* at 437.

129. *Id.* at 438. Had the taxpayers in *Banks* challenged the inclusion by claiming that portion was not an “accession to wealth,” the Court may not even have reached the issues decided in *Banks*, because if there was no accession to wealth in the first place, there would have been no need to consider whether the taxpayers exercised complete dominion over the award or if the taxpayers’ income had been assigned.

on *incomes* and not *receipts*. Courts have long ago recognized that Congress implemented the income tax to “carry out a broad basic policy of taxing net, not gross income,”¹³⁰ and the “term ‘[i]ncome’ as used in the Revenue Acts includes only gain or profit as a basis for income taxation and they exclude gross receipts or gross income as such a basis.”¹³¹ Where a taxpayer claims an amount is not income and Congress has prescribed a method to derive income from revenues,¹³² then, barring any constitutional infirmity,¹³³ courts need only determine whether the prescribed method is correctly applied.¹³⁴ Courts should apply the accession to wealth rule, however, in cases like *Murphy*, where it is unclear whether an amount is revenue or income and Congress is silent on how to make the distinction.

This practice would not turn judges into tax law activists. To the contrary, courts have given legislatures a substantial degree of latitude in how they exercise their taxing power as well as how they design tax policy.¹³⁵ Courts place no limitations on the items Congress may tax. Courts routinely support how Congress imposes taxes.¹³⁶ Congress has plenary power to impose excise taxes on revenues if it wishes.¹³⁷ It is not activism to ensure that Congress actually taxes income when it purports to do so.

In 1935, the Supreme Court decided *Stewart Dry Goods Co. v. Lewis*, a case involving the state of Kentucky’s graduated tax on gross sales receipts.¹³⁸ The tax rate on sales increased by three-twentieths of one percent for each additional \$100,000 of sales volume.¹³⁹ The Court

130. *Tank Truck Rentals v. Comm’r*, 356 U.S. 30, 33 (1958) (internal citations omitted); *see also McDonald v. Comm’r*, 323 U.S. 57, 66 (1944).

131. *St. Paul Fire & Marine Ins. Co. v. Reynolds*, 44 F. Supp. 863, 865 (D. Minn. 1942).

132. *See discussion infra*, notes 173-79.

133. *See, e.g., Eisner v. Macomber*, 252 U.S. 189, 218 (1920) (although the income tax statute prescribed a way to calculate the gain from a stock dividend, the Court held that stock dividends were not income).

134. *See supra* notes 125-29 and accompanying text.

135. *See discussion supra* notes 4 and 50.

136. *See discussion supra* note 50.

137. *See discussion supra* notes 58-77.

138. 294 U.S. 550 (1935).

139. *Id.* at 554. The tax rate on gross sales was 0.05% on the first \$400,000 of gross sales, 0.10% on the next \$100,000 of gross sales, and then increased by 0.15% for each additional \$100,000 of gross sales not exceeding an aggregate of \$1,000,000. The statute assessed a 1% tax rate on gross sales in excess of \$1,000,000.

struck down the tax as a violation of due process, holding the tax to be “unjustifiably unequal, whimsical, and arbitrary”¹⁴⁰ The Court’s underlying rationale in *Stewart* was based on two key principles. First, a graduated tax on gross sales imposed an incremental tax on volume, and arbitrarily imposed increasing taxes on identical transactions solely because one was performed “more often [sic] than the other.”¹⁴¹ The second principle was that a graduated tax on gross sales, unlike a graduated tax on income, did not bear a rational relation to a taxpayer’s ability to pay.¹⁴² The Court expressly distinguished sales from income, and graduated taxes on each, because “[a]n income levy by its very nature assures equality of treatment, because the burden of the exaction varies with increase or decrease of return on capital invested and with the comparative success or failure of the enterprise.”¹⁴³ Ability to pay was determined from profitability—by accounting for the business’s costs and management decisions.¹⁴⁴ Prior to this decision, the Court had consistently upheld progressive taxes based upon wealth or the ability to pay.¹⁴⁵ The Court expressly rejected Kentucky’s argument that gross sales were an acceptable proxy for income or ability to pay, as well as the argument that administrative convenience justified this simpler method.¹⁴⁶ Thus, the Court held that graduated taxes on receipts are unjustified when marginal receipts are a function of increasing volume.¹⁴⁷

140. *Id.* at 557.

141. *Id.* at 566 (“It exacts from two persons different amounts for the privilege of doing exactly similar acts because the one has performed the act oftener than the other.”).

142. *Id.* at 558.

143. *Id.* at 560.

144. *Id.*

145. *See* *Magoun v. Ill. Trust & Sav. Bank*, 170 U.S. 283 (1898) (upholding a progressive tax based on the value of the estate); *see also* *Knowlton v. Moore*, 178 U.S. 41, 109 (1900) (upholding a similar inheritance tax against a uniformity clause challenge); *see also* *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 24-25 (1916) (upholding the progressive rate structure of a federal income tax statute).

146. *Stewart Dry Goods Co.*, 294 U.S. at 560 (“If the commonwealth desires to tax incomes, it must take the trouble equitably to distribute the burden of the impost. Gross inequalities may not be ignored for the sake of ease of collection.”); *see also id.* at 563 (“The record fails to show that an income tax or a flat tax on sales would not accomplish the desired end.”).

147. *Id.* at 565-66; *see also* *Valentine v. Great Atl. & Pac. Tea Co.*, 299 U.S. 32 (1936) (invalidating an Iowa gross sales tax, citing *Stewart*); *In re Williams*, 1995 U.S. Dist. LEXIS 16222 at 23 (discussing *Stewart* when distinguishing a gross receipts tax

E. The Right Place: Murphy Revisited

A straightforward application of the accession to wealth rule within the framework of *Glenshaw Glass* illustrates why the D.C. Circuit decided *Murphy* correctly. *Murphy*'s award caused her wealth to accrete by \$70,000 in compensation for nonphysical injuries.¹⁴⁸ An administrative law judge determined that these same nonphysical injuries diminished her wealth by \$70,000.¹⁴⁹ Her accession to wealth from these injuries, therefore, was \$0.

The Government's "basis" argument misses the point. At its core, "basis" is nothing more than the mechanism chosen by Congress to measure the cost of property.¹⁵⁰ This mechanism serves two functions: (1) it measures taxpayers' gains, and (2) it ensures that Congress does not overstep its constitutional bounds and tax underlying property.¹⁵¹ Depreciation, depletion and amortization are simply statutory

from a gains tax). Compare *N.Y. Rapid Transit Corp. v. City of N.Y.*, 303 U.S. 573, 583 (1938) (upholding a fixed-rate gross receipts tax).

148. *Murphy v. IRS*, 460 F.3d 79, 81 (D.C. Cir. 2006).

149. *Id.*

150. I.R.C. § 1012 provides that "the basis of property shall be the cost of such property, except as otherwise provided . . ." The Code defines property as "tangible items." Treas. Reg. § 1.61-6(a) (1986).

151. See discussion *supra* note 68. Some argue that the primary purpose of basis is to ensure that the same dollars should not be taxed to the same taxpayer more than once. See Deborah A. Geier, *Murphy and the Evolution of "Basis,"* 113 TAX NOTES 576, 578 (Nov. 6, 2006). While basis does generally operate so as to prevent the taxation of previously taxed dollars, in *Murphy*'s case such previous taxation of her well-being could not constitutionally occur without apportionment as either a direct or capitation tax. If, as the Court discussed in *O'Gilvie*, Congress can tax a substitute payment in the same way manner as it could the original, why would constraints that protect the original not extend to the substitute? See discussion *supra* note 97. If the sole purpose of basis is to further a congressional policy, then there is no reason why Congress could not do away with the notion of basis entirely and impose an income tax on, for example, the entire amount of a purchase price received by a seller of property. It is unclear why such a tax would not be a direct tax imposed upon the value of the seller's property, simply deferred until such property is sold. Indeed, if such deferred direct taxes are constitutionally permissible, then it is not clear why it was necessary for the Supreme Court to recast inheritance taxes as excise taxes levied on the beneficiaries' *right to receive* an inheritance, as opposed to the owner's right to *devise*. Furthermore, if a parallel rationale applies that would enable Congress to levy an excise tax on a property owner's *right to sell* his or her property, then it is hard to see why it was necessary to adopt the 16th Amendment in the first place.

innovations to apply this mechanism over a period of time.¹⁵² Basis is not a constitutional requirement, but merely the method Congress *chose* to measure particular costs. It does not follow that basis is the *only* way to measure costs, nor does it follow that costs to which the concept of basis does not extend should not be measured. In Murphy's case, the costs of her loss were valued *at trial*, where the judge determined she had suffered harm in the amount of \$70,000.¹⁵³

Because Congress's power to tax is plenary and extends far beyond the power to tax incomes, Congress could tax Murphy's award whether or not it was income, as the IRS argued.¹⁵⁴ As stated above, the court had three options: (1) analyze whether the award was income subject to income tax, (2) hold the award to be property subject only to apportioned direct taxes, or (3) sustain the tax as an excise tax on the entire amount of the award. Although the court chose the first option, it is worth briefly discussing the other two.

First, had the court accepted Murphy's "human capital" argument, the award would operate as a restoration of capital.¹⁵⁵ As such, a tax on the award would be an unapportioned direct tax, and consequently fail for that defect.¹⁵⁶ Second, Congress could clearly levy an excise tax on the "right" to receive compensatory damages, as it has done with respect to inheritances in *Magoun*.¹⁵⁷ However, courts should be wary of converting tax statutes suffering from constitutional defect into other "legitimate" taxes.¹⁵⁸ While the Supreme Court has stated that the

152. I.R.C. § 1016 provides for "adjustments to basis"—a method by which a taxpayer can "recover" the cost of property over its useful life. Depreciation, amortization and depletion are conventions by which the taxpayer recovers the costs of property against the income the property produces. At the time of disposition, the adjusted basis of property is substantially below cost (possibly zero) and the taxpayer will pay tax on a larger (possibly the entire) amount of gain. However, since the cost is recovered over the life of its use, the Code ensures that the value of the property itself is accounted for at some point, and thus not taxed. *See, e.g.*, I.R.C. §§ 167-69, 197 and 199.

153. *See Murphy*, 460 F.3d at 81.

154. *See id.* at 86.

155. *See discussion supra* notes 20-21, 58-68.

156. *See discussion supra* notes 58-68.

157. *See discussion supra* note 65.

158. *See Gould v. Gould*, 245 U.S. 151, 153 (1917). In *Gould*, the Court held:

In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the government, and in favor of the

Sixteenth Amendment operated so as to bring all income taxes within the category of indirect taxes,¹⁵⁹ it has also recognized that income taxes are distinct from other forms of excise taxes.¹⁶⁰

If the court held that a defective income tax converted into a valid excise tax by default, several issues would arise. First, the court would have to determine what rate the tax would impose. Would the court impose a judicially determined rate? If so, they would violate the separation of powers. If not, would the court apply the Code's graduated rate structure to the award? Second, if courts apply the Code's graduated rates, would these rates apply to the award in isolation or at the marginal rate of the recipient's last dollar of taxable income? The absence of a statute authorizing a different excise tax would either result in a judicially-imposed tax or make the tax impossible to administer and arbitrary in operation.

III. *MURPHY* & WAGES: NO, THE SKY IS NOT FALLING

A. *Is Murphy Really a Tax Protestor's Dream Come True?*

After *Murphy* was decided, tax experts predicted the decision would give new inspiration to "tax protestors"—taxpayers who challenge (usually *pro se*) the government's power to tax wages based on a variety of long discredited constitutional theories, one of which happens to be a variation of the "human capital" theory.¹⁶¹ Tax protestors have made three general arguments based on this theory, none of which are any stronger after *Murphy*.

The first argument is that wages and labor are a "like kind exchange" from which neither the wage earner nor the employer recognize a gain. Tax exemptions for such exchanges are predicated upon an exchange of property of similar classification.¹⁶² This argument fails for two reasons. First, labor is not "property" as defined in Treas. Reg. § 1.61-6.¹⁶³ Second, even if labor were property, an exchange of

citizen.

Id.

159. See *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1, 19 (1916) (stating that the Sixteenth Amendment's effect was to prevent taking "an income tax out of the class of excises, duties and imposts and place it in the class of direct taxes").

160. See *supra* notes 138-47 and accompanying text.

161. See, e.g., *Yuen v. United States*, 290 F. Supp. 2d 1220 (D. Nev. 2003).

162. I.R.C. § 1031(a)(1).

163. See *supra* note 150.

labor for money would not qualify as an exchange of “property of *like kind* which is to be held either for productive use in a trade or business or for investment.”¹⁶⁴

The second tax protestor argument is that labor is human capital; therefore, the payment of wages for this labor constitutes a non-taxable return of capital.¹⁶⁵ This argument fails because a taxpayer’s labor is not capital, human or otherwise, for much the same reason a stock dividend was not income in *Eisner v. Macomber*. Assuming that labor is the result of an investment in human capital (one’s person), labor is severed from the employee when provided to the employer, while the person remains intact and undiminished after his labor is complete.¹⁶⁶ *Murphy* in no way alters the responses to these arguments.

Another related argument of tax protestors is that no gain is realized upon the payment of wages because wages represent the fair market value of the labor the employee provided.¹⁶⁷ This argument is equally frivolous as a matter of law, as the Code is clear that gains are calculated on the basis of *cost*, not fair market value at the time of exchange.¹⁶⁸ According to this rationale, no business would *ever* recognize gains from the sale of goods, as the very act of purchase is *prima facie* evidence of fair market value.¹⁶⁹ However, by rejecting the claim that *no* amount of wages received constitutes gain, does it necessarily follow that the *entire* amount of wages received is gain?

164. I.R.C. § 1031(a)(1) (emphasis added).

165. See *Parker v. Comm’r*, 724 F.2d 469 (5th Cir. 1984).

166. Compare *Eisner v. Macomber*, 252 U.S. 189, 212 (1920) (holding that stock dividends were not income because no separate property or capital was severed from the corporation and distributed to the shareholder).

167. See *Lonsdale v. Comm’r*, 661 F.2d 71, 72 (5th Cir. 1981) (appellants arguing that “the exchange of services for money is a zero-sum transaction, the value of the wages being exactly that of the labor exchanged for them and hence containing no element of profit”); see also *Davis v. United States*, 742 F.2d 171, 172 (5th Cir. 1984) (taxpayer arguing “that an individual receives no taxable gain from the exchange of labor for money because the wages received are offset by an equal amount of ‘costs of labor’”).

168. I.R.C. § 1012. Treas. Reg. § 1.1012-1(a) defines “cost” as “the amount paid for such property in cash or other property.” Thus, the cost basis of property may be the fair market value of property surrendered in the exchange, but not the property received.

169. Rational actors acting at arm’s-length usually transact at fair market value in the conduct of their daily affairs.

B. Wages in the Context of Glenshaw Glass

The Code distinguishes a taxpayer's gross income (the taxpayer's aggregate amount of income received in a given period) from its taxable income (the amount of income the government taxes).¹⁷⁰ The Code provides for this distinction through a statutory framework that generally operates as follows:

Gross Income
Less: Adjustments to Gross Income
 = Adjusted Gross Income¹⁷¹

Adjusted Gross Income
Less: Standard or Itemized Deduction(s)
Less: Personal and Dependency Exemptions
 = Taxable Income¹⁷²

This statutory framework is generally faithful to the historical notion of income as *net* income (as well as the principles set forth in *Glenshaw Glass* and the proposed accession to wealth rule) with respect to property or business operations. Consequently, taxpayers include only the gain from sales of property in gross income.¹⁷³ For example, the Code uses basis to determine gains from transactions in property.¹⁷⁴ Taxpayers calculate this amount on Schedule D and report this result as gross income on Form 1040.¹⁷⁵ Similarly, gross income derived from business is defined as “total sales, less the cost of goods sold, plus any income from investments and from incidental operations or outside operations or sources.”¹⁷⁶ Thus, business owners subtract both the basis of property sold, as well as an “expenditure basis” in the form of “ordinary and necessary” business expenses such as salaries, taxes paid

170. I.R.C. §§ 62-63.

171. *Id.* § 62.

172. *Id.* § 63.

173. I.R.C. § 61(a) (“[G]ross income means . . . gains derived from dealings in property.”).

174. Treas. Reg. § 1.61-6 (“gain is the excess of the amount realized over the unrecovered cost or other basis for the property sold or exchanged”).

175. Form 1040 (“U.S. Individual Income Tax Return”) is the form most individual taxpayers use to report their income tax liability. Gains and losses calculated on Schedule D (“Capital Gains and Losses”) are reported on Form 1040, line 13.

176. Treas. Reg. § 1.61-3.

and travel expenses.¹⁷⁷ They calculate their net income on Schedule C and report this result as gross income on Form 1040.¹⁷⁸ Similar methods are stipulated for rental and royalty income.¹⁷⁹ Each of these methods ensures that taxpayers report gains, and not aggregate receipts, from these activities.

There is no analogous statutory provision for wages and compensation for services. Taxpayers earning wages report the entire amount of earned wages as gross income, despite the fact that they may not receive the entire amount.¹⁸⁰ The Code does not allow wage earners to subtract the costs of earning those wages to arrive at “gross income from wages,” despite the fact that these costs can be substantial.¹⁸¹ Payroll taxes, state and local income taxes, and travel expenses are all costs that employees incur as a result of their employment, and these expenses would certainly qualify as ordinary and necessary business expenses under § 162.¹⁸² Yet the Code expressly prohibits a deduction for payroll taxes and commuting expenses, and allows deductions for state and local taxes only as itemized deductions.¹⁸³ Any taxpayer may elect to itemize their deductions, but these deductions may ultimately be disallowed by operation of phase-outs or the Alternative Minimum Tax.¹⁸⁴ The Code also assigns no value to the labor the wage earner

177. I.R.C. § 162 (“There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . .”).

178. Schedule C (“Profit or Loss From Business”), reported on Form 1040, line 12.

179. Schedule E (“Supplemental Income and Loss”), reported on Form 1040, line 17.

180. Form 1040, line 7.

181. For example, the Federal Insurance Contributions Act (“FICA”) imposes payroll taxes at a rate of 7.65% of gross wages (6.2% for Social Security taxes, and 1.45% for Medicare taxes). I.R.C. § 3101.

182. I.R.C. § 162. Payroll taxes paid by employers pursuant to I.R.C. § 3111 are deductible under this section. *See Kornhauser v. United States*, 276 U.S. 145 (1928) (holding that where a matter relating to business ordinarily and necessarily requires expenditure, it is an ‘ordinary and necessary’ expense of that business”).

183. I.R.C. §§ 164, 275. These deductions would be “above the line” for taxpayers operating a trade or business, and not subject to any limitation, *see infra* note 184, and taxpayers could still take either the standard or itemized deduction. Taxpayers earning wages, however, could only take these deductions if their aggregate itemized deductions exceed the standard deduction (\$5,150 for unmarried individuals in 2006), and are subject to limitations. I.R.C. § 63.

184. Personal exemption amounts are reduced when a taxpayer’s adjusted gross income exceeds \$100,000 (if unmarried) or \$150,000 (if married and filing a joint

provided. Thus, employees who work 75 hours are deemed to provide the same value of labor to their employers—\$0—as those who work 40 hours.¹⁸⁵

The income tax thus operates upon wage earners in a manner contrary to its original purpose, not only as recognized by the Supreme Court, but also as expressed by the language of § 61(a), its authorizing statute. Section 61(a) is ultimately a *source* statute. It embodies “the full measure of [Congress’s] taxing power,” and has been deemed “coextensive with” (and therefore given the same interpretation as) the Sixteenth Amendment, and thus establishes sources of income, not definitions.¹⁸⁶

Section 61(a) states, with respect to wages, “gross income means all income from whatever source derived, including (but not limited to) . . . compensation for services”¹⁸⁷ If the purpose of the sentence was to define *what* constitutes gross income, as opposed to *where* it is to be found, it would read as follows: “gross income means all *income*, from whatever source derived, including (but not limited to) . . . compensation for services” The word “including” would instead modify “income,” not “source,” and the phrase “from whatever source derived” would be nothing more than an appositive phrase evincing Congress’s acknowledgement of the fact that gross income may be found in other sources not listed therein. As written, however, the word “including” must be taken to modify “source,” and thus interpreted as Congress expressing its intent to tax income regardless of *where* it is found. This interpretation is consistent with the Court’s interpretation of the Sixteenth Amendment.¹⁸⁸

Predecessor statutes to § 61(a) support this reading. Section 22(a) of the Internal Revenue Code of 1939, for example, stated “‘Gross income’ includes *gains, profits, and income* derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses,

return). See I.R.C. § 151. Itemized deductions generally are phased-out when adjusted gross income exceeds \$150,500. See I.R.C. § 68(a) and (b). In calculating Alternative Minimum Tax liability, deductions for state and local taxes are disallowed. See I.R.C. § 56(b).

185. See discussion *infra* notes 204-05.

186. See *Helvering v. Clifford*, 309 U.S. 331, 334 (1940); see also discussion *supra* notes 75 and 76.

187. I.R.C. § 61.

188. See generally *Brushaber v. Union Pac. R.R. Co.*, 240 U.S. 1 (1916).

commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .”¹⁸⁹ The placement of “income” in this sentence, after the terms “gains” and “profits,” justifies interpreting the word consistent with its definition as a gain, as opposed to its broader definition of “inflows” or “receipts.”¹⁹⁰ Furthermore, the Tariff Act of 1894 provided for the exclusion of costs incurred when paying taxes on wages.¹⁹¹

These statutes and the Court’s statements together illustrate the historical understanding that the amount of wages that constitutes income to a wage earner is less than the full amount of wages he actually earns. So why is it that Congress never made provisions for employees to adjust for the costs they incur when earning their income? The Revenue Act of 1913 imposed a tax of 1% on income exceeding the first \$3,000 of taxable income (\$4,000 if married).¹⁹² At the time, this amount excluded 98% of workers.¹⁹³ Congress could have realistically determined that such a provision was unnecessary based on the improbability that the costs incurred would exceed that amount.¹⁹⁴ Moreover, the personal income tax evolved over time to encompass a variety of personal deductions and exemptions unrelated to income, such as deductions for the mortgage interest paid on a primary residence, college tuition, interest on student loans, retirement savings and medical expenses. It could be argued that these deductions have the effect of accounting for the costs of earning wages.¹⁹⁵

189. I.R.C. § 22(a); *see also* *Comm’r v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955).

190. According to the rule of *noscitur a sociis*, a canon of interpretation meaning “a word is known by the company it keeps.” *See generally* *Jarecki v. G. D. Searle & Co.*, 367 U.S. 303, 307 (1961). Congress did not change the definition’s application to wages with subsequent textual changes to the definition of gross income, because, as the Court acknowledged in *Glenshaw Glass*, Congress did not intend to alter the scope of “gross income” in any way when it altered the language of the statute. *See Glenshaw Glass Co.*, 348 U.S. at 432.

191. *See* *Pollock v. Farmers’ Loan & Trust Co.*, 157 U.S. 429, 429 n.1 (1895).

192. *See* *Brushaber*, 240 U.S. at 23.

193. *See* Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1, 15 n.40 (2002).

194. *See supra* note 50 and accompanying text.

195. I.R.C. §§ 62(a)(6)-(20), 163(h)(3), and 213.

While each of these justifications may have been true at some point, none are true today. With the exception of the standard deduction, there is no single exemption amount available to all wage earners. The current amount of the standard deduction does not have the effect of exempting reasonably conceivable costs, as the amount is less than the statutory cap on payroll taxes.¹⁹⁶ Personal exemptions and itemized deductions “phase out” after a certain adjusted gross income is exceeded.¹⁹⁷ Moreover, these are *personal* deductions—a product of legislative policy designed to ease burdens on taxpayers unrelated to the cost of producing income.¹⁹⁸ Finally, deductions are a matter of “legislative grace.”¹⁹⁹ Congress is bound by few constitutional constraints when determining eligibility of deductions, and can grant or disallow them on the basis of almost any condition.²⁰⁰

C. The Accession to Wealth Rule Applied:
How Much of Wages are Income?

When an employee earns its salary, its wealth accretes by the amount of the salary earned. However, the employee’s wealth

196. The standard deduction for single taxpayers in 2006 is \$5,150. I.R.C. § 63. FICA imposes a payroll tax of 7.65% on the first \$94,200 of wages (\$7,206.30). I.R.C. § 3101.

197. I.R.C. §§ 68 and 151.

198. See *General Explanation of the Tax Reform Act of 1986*, H.R. Rep. No. 99-3838, at 8-10 (Conf. Rep.). The Joint Committee report reveals that the overriding goals for these deductions were simplicity and progressivity:

Significant increases in the standard deduction and modifications to certain personal deductions provide further simplicity by greatly reducing the number of taxpayers who will itemize their deductions. . . . The Act retains the most widely utilized itemized deductions, including deductions for home mortgage interest, state and local income taxes, real estate and personal property taxes, charitable contributions, casualty and theft losses, and medical expenses (above an increased floor). . . . In addition to ensuring that high-income taxpayers pay their share of the Federal tax burden, the Act provides tax relief to low-and middle-income wage earners. To achieve this goal, the Act substantially increases the standard deduction (the prior-law zero bracket amount) and almost doubles the personal exemption . . . to ensure that no families below the poverty level will have Federal income tax liability.

Id.

199. See *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

200. See *Comm’r v. Nat’l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-49 (1974) (“The propriety of a deduction does not turn upon general equitable considerations, such as a demonstration of effective economic and practical equivalence.”).

diminishes by the amount of payroll, state and local income taxes assessed on this salary, as well as other expenses “ordinary and necessary” to earning this salary, such as commuting expenses.²⁰¹ Thus, under the accession to wealth rule, the amount of gain that should be reported as gross income is the amount by which the employee’s salary exceeds these costs. Congress should adopt provisions to recognize an “expenditure basis” in these costs and ensure that it taxes wages in parity with other sources of income.

Assuming the entire amount of wages are receipts and not income, Congress can, and does, tax these receipts through the imposition of excise taxes.²⁰² The FICA tax, for example, is an excise tax on the first \$94,200 of wage receipts.²⁰³ Why, then, should Congress provide for the determination of wage income from wage receipts in light of this excise tax alternative? For two reasons: (1) the income tax’s graduated rate structure, and (2) the Alternative Minimum Tax and phase-out of other deductions.

1. Graduated Structure of Income Tax Rates

This Court’s rationale in *Stewart* is theoretically applicable to wage earners.²⁰⁴ A merchant’s sale of a good to a customer is economically indistinguishable from an employee’s “sale” of labor to his employer. Volume factors into calculating employee wages in a number of ways: hourly rates, commissions on sales, or bonuses calculated on the basis of working in excess of a fixed number of hours or number of deals closed in a year.

Consider the following example. Two employees, A and B, each earn \$10 per hour. A state law imposes a 10% tax on the first \$300 of wages, and a 20% tax on the next \$300 of wages. In week 1, A works 20 hours and B works 30 hours. A earns \$200 and pays \$20 in taxes,

201. An argument can be made that wealth does not diminish because the state provides services in exchange for taxes paid. While taxpayers may enjoy such benefits, they do not necessarily have an enforceable right to them vested to the extent that they should be considered an “accession to wealth.” See generally, Calvin R. Massey, *Takings and Progressive Rate Taxation*, 20 HARV. J.L. & PUB. POL’Y 85 (1996).

202. See discussion *supra* notes 69-71, 181 and 196.

203. I.R.C. § 3101. The taxable amount of wages is scheduled to increase to \$97,500 for 2007. See “History of the OASDI contribution and benefit base,” available at <http://www.ssa.gov/OACT/COLA/cbb.html>; see also *supra* notes 181 and 196.

204. See *supra* notes 138-47 and accompanying text.

while B earns \$300 and pays \$30 in taxes. In week 2, A and B each work an additional 10 hours—30 and 40 respectively. A earns \$300 and pays \$30 in taxes. B earns \$400, but pays \$50 in taxes. While A and B each pay a \$1 tax on their 30th hour of labor, B pays a \$2 tax on his 31st hour. B pays an additional 10% tax on each additional hour worked, essentially, according to *Stewart*, for engaging in a work hour “more often” than A—with no recognition of the incremental costs B incurs by working that additional hour.²⁰⁵

Consequently, the Court’s rationale in *Stewart* could theoretically limit Congress to assessing a uniform tax rate on wage receipts calculated on the basis of volume. Where employees are paid a salary, however, Congress would still be free to impose a progressive rate excise tax, as clearly indicated in *Magoun* and *Knowlton*.²⁰⁶ Congress would thus need to establish a method to distinguish volume-based wages, yet should also anticipate a significant shift away from salaries to some type of volume-based wage structure.

2. Deductions, Exemptions, Phase-Outs and the Alternative Minimum Tax

The Court’s decision in *Stewart* carried few implications for wages when the Court decided the case, as income tax exemptions were large enough at the time to compensate for the costs employees incurred.²⁰⁷ The current Code likewise provides for numerous deductions and

205. See *Stewart Dry Goods Co. v. Lewis*, 294 U.S. 550, 566 (1935). Volume also distorts income calculations if A and B earn different hourly rates. For example, if A earned \$15 per hour and B earned \$10, each would pay \$30 in taxes on \$300 of wages, despite the fact that B had to work 10 additional hours for the additional \$100.

206. See discussion *supra* notes 65 and 145.

207. See Geier, *supra* note 193, at 24.

In 1939 (and, indeed, through 1949), the combined employer and employee Social Security tax was two percent (one percent each), which was imposed on wages up to \$3,000. Because of the generous personal exemptions under the income tax—\$2,500 for married couples and \$1,000 for single taxpayers, along with \$400 for each dependent, at a time when few households earned as much each year—the two-percent payroll tax was the only tax paid by the vast majority of lower- and middle-class workers.

Id. This contrasts sharply with 2004, where only 17.2% of taxpayers earning wages earned less than \$10,000, and the standard deduction and personal exemptions were \$4,850 and \$3,100, respectively. See IRS Statistics of Income Tax Stats, *Individual Income Tax Returns Publication 1304 (Complete Report)* (2004), available at <http://www.irs.gov/taxstats/indtaxstats/article/id=134951,00.html>.

exemptions from income.²⁰⁸ Some could argue that these provisions also function as an *approximate*²⁰⁹ calculation of income from receipts, to which a few observations are available in response. First, while there are personal and dependency exemptions available to taxpayers, these amounts are far lower in proportion to wages than those of 1935, and do not have the same compensating effect.²¹⁰ Second, the deductions and exemptions currently available are mostly for personal expenditures.²¹¹ Certain deductions that would be considered wage expenditures are allowable, but only as itemized deductions.²¹² Third, to the extent deductions and exemptions are available, they are denied to many wage earners due to limitations such as phase-outs and the Alternative Minimum Tax.²¹³ Itemized deductions are also subject to certain limitations.²¹⁴ Since adjusted gross income is calculated before subtracting itemized deductions, phase-outs deny many wage earners the ability to deduct the wage expenditures that the Code actually allows. Furthermore, whereas other taxpayers' adjusted gross income reflects their net income, eligibility for permitted deductions is determined by wage earners' gross receipts.²¹⁵ Both structural inequities are especially acute where adjusted gross income thresholds are exceeded because of an increased volume of labor.²¹⁶ Finally, the Alternative Minimum Tax, a parallel mandatory maximum tax system, disallows deductions for wage expenditures when calculating alternative minimum taxable income.²¹⁷

208. See *supra* note 195 and accompanying text.

209. See, e.g., *Stewart Dry Goods Co.*, 294 U.S. at 559-60 (Kentucky asserting that a gross receipts tax was a "rough and ready method of taxing gains" and a "less complicated and more convenient [method] of administration than an income tax").

210. See discussion *supra* note 193; compare Geier, *supra* note 193, at 24 (reporting that by 1939, only about 5% of the population paid income taxes), with *Individual Income Tax Returns Publication 1304*, *supra* note 207 (publishing that in 2004, the IRS reported receiving 132.2 million tax returns, 67.9% of which paid income taxes).

211. See discussion *supra* note 195 and accompanying text.

212. See discussion *supra* notes 183-84.

213. See discussion *supra* note 184.

214. Medical expenses are deductible only to the extent they exceed 7.5% of adjusted gross income. I.R.C. § 213. Other miscellaneous itemized deductions are subject to a 2% floor. I.R.C. § 67.

215. See discussion *supra* notes 180-85.

216. See discussion *supra* notes 204-05.

217. I.R.C. § 56(b).

IV. A PROPOSAL FOR A WAGE EXPENDITURE BASIS

The preceding sections discussed why it is entirely proper for courts to play a role in interpreting tax laws and identified current issues with respect to wages in the context of Supreme Court precedent. The discussion above demonstrates that tax laws should recognize and adjust for some form of wage expenditure; however, it is Congress, and not the courts, that must ultimately address how to recognize such a provision. This Part proposes the adoption of a “wage expenditure basis,” a concept that balances the notion of equity for wage earners with established federal policies and administrative convenience.

A. The Wage Expenditure Basis

As discussed in Part II, basis is the mechanism by which the Code measures the costs of property.²¹⁸ The Code also incorporates an “expenditure basis” for taxpayers who operate a trade or business to deduct from their gross receipts.²¹⁹ This expenditure basis includes salary expenses, taxes, fees, rents, travel and other costs unrelated to property.²²⁰ A wage expenditure basis would operate in a similar fashion, i.e., a separate schedule on which wage earners calculate their “gross income from wages” from their “wage receipts.”

The wage expenditure basis would be calculated by the following formula:

$$B_{we} = [P + T + (E_{mw} * 92.35\%)]$$

where:

- B_{we} = Wage expenditure basis;
- P = Payroll taxes withheld;
- T = State and local income taxes withheld; and
- E_{mw} = Minimum wage equivalent.

218. See discussion *supra* notes 173-75.

219. See discussion *supra* notes 176-78.

220. See discussion *supra* notes 177 and 182.

Gross income from wages would then be calculated as follows:

$$I_w = W_a - B_{we}$$

where:

- I_w = Gross income from wages;
- W_a = Aggregate wage receipts; and
- B_{we} = Wage expenditure basis.

1. Taxes

Payroll taxes and income taxes each qualify as expenses “ordinary and necessary . . . in carrying on any trade or business.”²²¹ The costs to employees for these items increase in direct proportion to the amount of wages earned. The Code, however, expressly disallows deductions for employee payroll taxes,²²² and state and local taxes are available only as itemized deductions.²²³ The wage expenditure basis recognizes these significant costs to all employees without imposing an additional administrative burden on the government. These items are each reported on Form W-2, which is available to both employees and tax authorities.²²⁴ While each employee taxpayer’s state and local tax liability may vary from the amounts actually withheld from wages, these taxpayers can include refunds as income and deduct additional payments on the subsequent year’s wage expenditure basis schedule.²²⁵

2. The Minimum Wage Equivalent

The minimum wage equivalent concept allows Congress to assign a base value to the employee taxpayer’s labor, recognize variations in the amount of time worked, and account for other miscellaneous costs of labor in an administratively convenient way. The federal minimum wage represents Congress’s determination of the amount of income

221. See discussion *supra* notes 177 and 182.

222. I.R.C. § 275.

223. I.R.C. § 164.

224. Employers send end of year W-2 forms to their employees as well as to the IRS and state tax authorities.

225. Such an approach would be consistent with current practice. State and local income tax refunds are includible in gross income in the year received under the Tax Benefit Rule. See I.R.C. § 111.

necessary to maintain “the minimum standard of living necessary for the health, efficiency, and general-well-being of workers.”²²⁶ Congress thus frustrates its labor policy through its tax policy by imposing income taxes on employees who earn the minimum wage. By providing a deduction on the basis of the minimum wage the employee would have earned for the work performed, the Code would truly embody a policy of taxing “gains” derived from labor, while Congress would move further toward its stated goal of ensuring a minimum standard of living for low-income workers by exempting minimum wage earners from income tax.²²⁷

The minimum wage equivalent is also administratively convenient. Congress could reasonably conclude, for example, that when it sets the minimum wage rate, it takes into account the various incidental costs of earning wages, such as commuting and meals. The minimum wage equivalent thus operates as a “catch-all” exclusion, eliminating the need to provide a detailed itemization of varied miscellaneous costs, and ensuring simplicity for taxpayers and tax agencies alike.

Furthermore, the minimum wage equivalent eliminates the bias against taxpayers who earn higher wages by working longer hours. Employees who are compensated on the basis of volume would deduct a minimum wage equivalent calculated on such basis. Without adjusting for quantity of work, an employee who works 30 hours a week yet earns less per hour could pay higher income taxes than an employee who works 20 hours per week yet earns more per hour.²²⁸ With the minimum wage equivalent, the employee working 30 hours per week and paid hourly subtracts a larger minimum wage equivalent than the employee

226. Fair Labor Standards Act, 29 U.S.C. § 202 [hereinafter “FLSA”]. A number of states have minimum wage laws requiring higher compensation than that of FLSA. See Minimum Wage Laws in the States—January 1, 2007, <http://www.dol.gov/esa/minwage/america.htm>. Congress could allow a deduction for these amounts, thus deferring to state determinations of minimum standards of living, or it could use the federal minimum wage for the sake of simplicity. The same administrative convenience also makes a federal minimum wage equivalent more advantageous than unemployment compensation, which also varies by state. Unemployment compensation may be more doctrinally “pure” to the extent that it represents value that accrues to a wage earner who does not engage in any labor, and any wages in excess of this amount would be—literally—“gains from labor.”

227. By imposing taxes only on the gains that accrue to taxpayers after providing for “minimum living standards.” See 29 U.S.C. § 202.

228. See example *supra* note 205.

working 20 hours per week, and their tax liability adjusts accordingly.²²⁹ Employees paid a salary, by contrast, could deduct the equivalent of 40 hours per week, the standard workweek under the FLSA.²³⁰

Minimum wage earners also currently pay payroll taxes of 7.65% under FICA.²³¹ The wage expenditure basis formula adjusts the minimum wage equivalent to 92.35% of the minimum wage payable because the entire amount of payroll taxes withheld is also excluded.²³²

3. The Impact of the Wage Expenditure Basis

The wage expenditure basis adjusts wages for the costs employees incur in earning them. This concept is consistent with the accession to wealth rule because employees' wealth increases by their *net* wages. Tax withholdings, for instance, are neither realized nor subject to an employee's complete dominion, as understood within the context of *Glenshaw Glass*. The minimum wage equivalent, though possibly greater than the costs some employees would incur, strikes the appropriate balance between the equity in recognizing these costs and the need to minimize the administrative burden in so doing.

Congress could adopt the wage expenditure basis with minimal impact on the statutory framework of the Code. Ultimately, the wage

229. The minimum wage equivalent would allow each earner to subtract their wage expenditure basis and report only their "gains" from wages as gross income. Thus, in the example in note 205, *supra*, A and B's minimum wage equivalent would be \$95.12 and \$142.68, respectively. Their gross income from wages would be \$181.93 and \$134.37, respectively. For a similar reason, the minimum wage equivalent concept would also alleviate the inequity of the marriage penalty, the repeal of which is scheduled to expire in 2010. In two-earner families, the second earner's first dollar of income is taxed at the marginal tax rate of the first earner's last dollar of income. The minimum wage equivalent could also obviate the need for personal exemptions for each worker, while continuing to allow for dependency exemptions, which could still be phased-out for high-income workers.

230. Employees with a portion of their compensation calculated on the basis of time, such as bonuses in excess of a minimum hour threshold, could also deduct the hourly equivalent of their work since there would be evidence provided by employers of hours worked.

231. *See supra* note 181.

232. These adjustments thus continue Congress's policy of disallowing "double deductions." *See* I.R.C. § 62 ("Nothing in this section shall permit the same item to be deducted more than once."). State and local income taxes did not significantly affect this percentage, and thus were excluded from the minimum wage equivalent adjustment.

expenditure basis would: (1) require a new schedule similar to Schedule C or Schedule E, (2) add two new exclusions from income—payroll taxes and the minimum wage equivalent, and (3) reclassify the itemized deductions for state and local income taxes as an exclusion on this new schedule. The wage expenditure basis would make the Code far more progressive and Congress could also offset the cost of correcting these structural inequities by adjusting marginal tax rates accordingly.²³³ Congress would also be free to continue its practice of allowing additional personal deductions both above and below the line to support worthwhile public policies, subject to the same adjusted gross income ceilings, phase-outs and inclusions under the Alternative Minimum Tax. Each increase in the minimum wage would carry greater economic effect, as workers would receive each additional dollar tax-free. Finally, each minimum wage increase would also operate as an income tax reduction, and Congress would no longer “stand on both sides” of the transaction by voting itself more tax revenue with each additional increase in the minimum wage.²³⁴

V. CONCLUSION

As of this writing, it is not yet known how *Murphy* will finally be resolved. The original panel’s decision to vacate and rehear the case is just one of many unexpected developments in Ms. Murphy’s long quest for her refund. This unusual move places the panel in an interesting position. The panel can reaffirm a controversial and widely criticized decision, strengthened by a more comprehensive constitutional analysis

233. Taxpayers earning less than \$10,712 would not need to file at all (assuming a minimum wage of \$5.15, a 40-hour week and a 52-week year).

234. The current proposal to raise the minimum wage to \$7.25 would, if passed, reduce each taxpayer’s taxable income by an average \$4,368 (based on a 40-hour week and a 52-week year) using the minimum wage equivalent. When Congress raises the minimum wage, it is requiring third parties—employers—to increase the amount of wages paid to employees. Congress directly benefits from increased income and payroll tax revenue. The structural design of the minimum wage equivalent eliminates this benefit. Under analogous circumstances in corporate law, when a corporation’s board of directors engages in self-dealing, courts review such transactions under a more stringent standard. *See Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (applying the test of intrinsic fairness to a self-dealing transaction); *see also Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (“When directors of a . . . corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.”).

and free of the original opinion's mistakes. In so doing, the panel risks reversal either en banc or by the Supreme Court. Alternatively, the panel could reverse itself, avoiding the controversy and criticism, yet risking public perception that the panel is vulnerable to both. The unpredictable history of this case undermines the utility of predictions; I will note only that the panel could have achieved the latter result without risking the negative consequences by allowing the case to proceed en banc. The panel will hear oral arguments on April 23, 2007.

Whatever the ultimate outcome, the D.C. Circuit provided a public service by reminding Congress of the difference between receipts and income. Courts do not often have the opportunity to make this distinction, but they have recognized it, and *Murphy* will hopefully serve to remind legislatures of their obligation to do so as well. Going forward, Congress should ensure that the Internal Revenue Code taxes gains, not receipts.

Where the Code may have at one time taxed wages at a level where the distinction between revenues and income was largely an academic question, today the distinction is very real to taxpayers. Congress now taxes a greater proportion of wage earners as well as a larger proportion of the wages they earn. At the same time, wage earners bear increasing costs of employment. The wage expenditure basis proposed in this article seeks to resolve the disparity between the taxation of wages and the taxation of other forms of income, and succeeds in a way that is faithful to the notions of equity, progressivity and simplicity.